No. 80-1484

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In the

Supreme Court of the United States

OCTOBER TERM, 1980

U.S. STEEL CREDIT CORPORATION,

Petitioner,

vs.

AMERICAN FLETCHER MORTGAGE COMPANY, INC.,
AMERICAN FLETCHER NATIONAL BANK AND TRUST COMPANY, and
AMERICAN FLETCHER CORPORATION,

Respondents.

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

The most notable feature of Respondents' Brief is its failure to come to grips with any of the substantive points raised in U. S. Steel Credit Corporation's Petition for Certiorari, other than by ritual repetition of the very mispronouncements which prompted the Petition.

Thus, on the question, whether interest is a form of "profits" within the meaning of the *Howey-Forman* test, Respondents merely parrot the Court of Appeals' holding that interest is not profits, because it involves a fixed rate of return which does not fluctuate with profits (Resp.

Br., p. 8). How, then, can any of the interest-bearing instruments, which Congress described as "securities" in its statutory definitions, qualify as "securities"? And what about the "economic reality," noted in *Williamson* v. *Tucker*, 632 F.2d 579, 604 (5th Cir. 1980), that without profits there will be no return of interest or principal on the notes? Respondents offer no answer to these questions, raised in our Petition (Pet. pp. 16-17).

Again, Respondents point to the Court of Appeals' finding that there was no "expectation of profits to be derived from the entrepreneurial or managerial efforts of others," because Petitioner's decision to participate "was based upon its own business judgment" (Resp. Br. p. 4, 7). Does *Forman*[1], then, require that the "expectation" of profits, no less than the profits themselves, must derive—and derive "solely"—from the efforts of others? Do the Securities Acts protect only *imprudent* investors? Respondents attempt no answers to these questions, posed in our Petition (Pet. pp. 18-20).

Respondents recite the Court of Appeals' holding that Petitioner's participations failed the *Howey-Forman* profits-derivation test because the Mortgage Company had no authority to modify the loan agreement, release the security, or decline to foreclose in the event of a default, without Petitioner's consent (Resp. Br. pp. 6-7). How, then, can a corporate mortgage bond qualify as a "security," since a bondholder has all of the above rights (Pet. pp. 12, 24-25)? These rights, moreover, are not profit-producing. They are stop-loss precautions at best. Here again Respondents seek to dispose of these points by ignoring them.

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[1] *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 852, 95 S.Ct. 2051, 2060 (1975).

Like the Court of Appeals, Respondents attempt to gloss over important distinctions between the posture of the lead bank as a commercial lender and the posture of an investor in a loan participation (see Pet. pp. 18, 21-22, 24) by repeatedly misdescribing USSC as a "lender" and its participation as a "loan" (Resp. Br. pp. 2, 3, 4, 6, 7, and 12). Beyond this exercise in false labeling, plus unsupported assertions that Petitioner had "all significant rights of a lender" (Resp. Br. p. 6), Respondents fail to specify a single creditor's right possessed by USSC. Though Respondents seek to pass off the Mortgage Company as a mere "nominal party to the loan agreements" (p. 6), no one has yet suggested that any of the participants, least of all USSC, had any rights against the borrower. The "economic reality" of lacking rights against the borrower was forcefully brought home to USSC when the Mortgage Company took it upon itself to release the borrower, the mortgage, the contractor, and the contractor's bonding company, without (so we contend) USSC's consent.

USSC was not even a creditor of the Mortgage Company. When, in response to periodic draw requests from the Mortgage Company, USSC made payments to the Mortgage Company, USSC had no absolute right to repayment, even of principal, much less interest, on these payments. Loans, by definition, are "obligations to repay absolutely", *Depositors Trust Company* v. *Maryland Casualty Company*, 174 A.2d 288, 291 (Md. 1969); *In Re Grand Union Company*, 219 F. 353, 356 (2d Cir. 1915). It is true that USSC had a right to share in whatever sums, if any, the Mortgage Company might collect from the borrower. But this *conditional* right to share in receipts does not make USSC a "lender" any more than

an income beneficiary of a trust is a "lender," by reason of his conditional right to share in any income realized by the trust. Respondents come to grips with none of these points.

Beyond the superficiality of Respondents' arguments, Respondents' Brief is riddled with potentially misleading inaccuracies:

1. Contrary to Respondents' assertion in footnote 1 on page 6 of their Brief, there do not appear to be any significant differences in terms between the participations involved in the Colocotronis loans and the participations in the case at bar. Colocotronis merely highlights the importance of distinguishing between the posture of a loan participant and that of a lead bank, vis-a-vis the loan, because of the great geographical distances between the participants and the borrower's activities, which existed in Colocotronis. See Notes, *The Colocotronis Dispute: When is a Loan Participation Share a Security?* 13 J. Int'l. Law & Econ. 165 (1978) and *Loan Participations as Securities,* 8 Cal. W. Int'l. L. J. 510 (1978). The opinion of commentators that loan participations should qualify as "securities" is not limited to international loans. See *Bank Loan Participations: The Affirmative Duty to Disclose Under SEC Rule* 10b-5, 27 Syracuse L. Rev. 807 (Spring, 1976).

2. Contrary to the statement on page 10 of Respondents' Brief, there is nothing in the recital of facts in *Commercial Discount Corp.* v. *Lincoln First Commercial Corp.*, 445 F.Supp. 1263 (SDNY 1978) or in *NBI Mortgage Investment Corp.* v. *Chemical Bank* [1976-1977] Fed. Sec. L. Rep. (CCH) ¶95,632 (SDNY 1976) and [1977-1978] Fed. Sec. L. Rep. (CCH) ¶96,066 (SDNY 1977) to

indicate that the loan participants in those cases had no voice in foreclosure decisions.

3. Contrary to the statement on page 10 of Respondents' Brief, U. S. Steel Credit Corporation has never urged a return to the literal approach of *Lehigh Valley Trust Co.* v. *Central National Bank of Jacksonville,* 409 F.2d 989 (5th Cir. 1979) in determining whether or not a loan participation qualifiies as a "security" (Pet. p. 13-14, 22). Petitioner's point is not that the *Howey-Forman* tests should be changed, but merely that the Court of Appeals has misconceived and misapplied them (Pet. p. 12, 17, 20).

4. Equally untrue is Respondents' statement on page 11 that the presumption of "security" status, announced by the Second Circuit in *Exchange National Bank* v. *Touche Ross & Co.,* 544 F.2d 1126 (1976), with respect to instruments defined as "securities" in the Acts, was never pointed out in USSC's briefs, below.[2] In point of fact, *Exchange National Bank* v. *Touche Ross & Co.* was fully analyzed and discussed on page 13 of USSC's Reply Brief before the Court of Appeals, where this statement appears:

> "*Exchange National Bank* differs from other jurisdictions in its construction of the Securities Acts definitions, only in one respect: i.e. that if a particular instrument, like a 'note,' is expressly defined in the Act as a 'security,' the burden shifts to the party contesting 'security' status to prove that the 'context otherwise requires' ".

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[2] This marks the second time in this appeal in which counsel for the Mortgage Company have falsely charged USSC with failing to argue below points which in fact had been carefully briefed below. (See Court of Appeals' opinion, fn. 4, App. 7a.)

Consistent with their usual ploy of mislabeling that which cannot otherwise be discredited, Respondents characterize the Second Circuit's approach to the Securities Act definitions as a "literal" approach (Resp. Br. p. 10). Any objective reading of Judge Friendly's exhaustive opinion in *Exchange National Bank* reveals, however, that the Second Circuit gives full consideration to the context. This decision does impose upon the party opposing security status the burden of proving that an instrument defined by Congress as a "security" is "required" (not merely permitted) by the context to be regarded as a non-security.

The Second Circuit's approach to the "security" question is a better approach than that of the Seventh Circuit for at least two reasons. First, the Second Circuit, while not confining its attention to the language of the Acts, pays heed to the statute, while the Seventh Circuit tends to *ignore* the statutory language. Thus, the Second Circuit would never fall into the error of holding, as the Seventh Circuit has done in the case at bar, that interest is not a form of profits, because that holding effectively reads out of the statute interest-bearing instruments, like notes, certificates of deposit, and loan participations, which Congress plainly contemplated would qualify as "securities" in most instances. The test of "security" status of a loan participation should not be whether it has the attributes of a share of stock, but whether it has the attributes of a fixed-return "security" like a corporate mortgage bond. Consistent with the statute, the Second Circuit's presumption is one of *inclusion,* whereas the Seventh Circuit's restrictive approach militates toward *exclusion.*

Secondly, the Second Circuit's presumptive inclusion rule not only fits the language of the statute; it also complies with the repeated urgings of the Supreme Court that the Securities Acts should be broadly and flexibly construed to achieve their remedial purposes. *Aaron* v. *SEC,* 100 S.Ct. 1945, 1960 (1980); *Tcherepnin* v. *Knight,* 389 U.S. 332, 336; 88 S.Ct. 548, 553 (1967). (See Pet. p. 11, 17.)

CONCLUSION

The crux of the matter is that the distinct trend of lower court decisions on "securities" questions is toward increasingly restrictive interpretation of the Securities Acts. The Second Circuit stands alone against this trend. If the Supreme Court remains of the view that the Securities Acts should be *broadly* construed, it is time to blow the whistle on this trend before the remedial objectives of the Securities Acts have been completely emasculated.

U. S. Steel Credit Corporation's Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit herein should be granted.

Respectfully submitted,

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